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IFRS and the financial market crisis

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IFRS and the financial market crisis

The consequences of the financial market crisis have reached the IFRS by the changes in IAS 39 and the draft of IFRS 7 in the end, too. After a strong political pressure the standard compositor IASB was forced to his accounting conventions. A long lead time which has resulted its expression in a dire consequence and concerns in many areas of the financial markets is inherent in the crisis, though. Some changes were already implemented as the first relief action, further steps will follow or already are under way.

How everything started

Careless guidelines for the bank borrowings as well as the low interest policy of the U.S. central bank Federal Reserve provided a surplus of cheap money since the end of the nineties. The real estate prices increase due to the high demand. At first the increase in value of the houses correspondingly makes the risk seem low. Mortgage loans, however, are also allocated to credit standing weak borrowers, so-called Subprimes, at this time. The problem consists in the flexible interest. Because this is confirmed in the contract only for limited time. The hazard that the debtors cannot pay the rates any more threatens at increasing interest. Exactly this happens as of the middle of the year 2004. Originally the interest was lowered to 1.0% from the U.S. central bank (FED). This should fight the results of the New Economy bubble, led it to broader problems, however. The FED key interest rate increases from 1.0% in the year 2004 to 5.25% in 2006. By the variable interest rates the mortgage rates rise. Many house-owners are confronted with interest charges which they cannot pay. Many of the persons affected must leave their houses, through this the supply of real estate rises about the demand and due to this surplus, the house market and the prices break down.

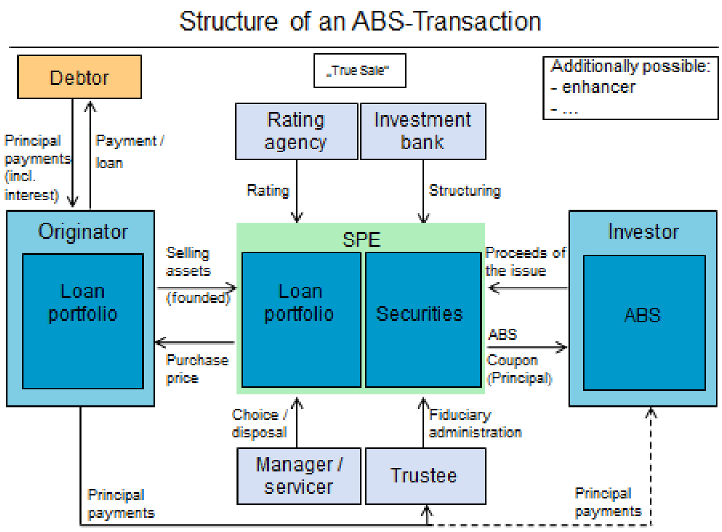
Who is guilty?

Who to blame for the crisis in the end? This question is hard to answer. By the low interest there existed a surplus of liquidity on the market. There were the irresponsible bank borrowings which led to the so-called Subprimes later on. Complex financial products are finally laced up from the mortgage loans at the banks. They securitize these mortgages into complicated financial vehicles. No one has the more accurate overview of how these are structured and where the risk ultimately lies. Even rating agencies lose the insight. The headword transparency plays an important role both for the structure of these complex products and in the confused transaction to further market participants. Accounting played a major role. Are the current, internationally applied standards not up to the crisis and provide the economic situation of the company worse off than it actually is, or flip them against the reality? Is the Fair Value the right valuation standard? It finally comes to the crisis of confidence in the capital market and between banks.

Securitization

The loans given to home owners are not always held by the bank in the books, but securitized and passed on to the market. For the securitization of mortgage loans banks use various instruments that can be summarized under the umbrella term asset-backed securities (ABS). The structure of the transaction is very complex (Fig. 1). Simply put, sold the bank (originator) the credit to an especially for the transfer established SPV (Special Purpose Entity, SPE). This assumes the securitization and resale to an investor (other banks, hedge funds, etc.). In annual reports of banks is to read that they are also active market makers for these securities and thus acquire the shares of the products again which they originally sold. From this, the far-flung market for such products and can recognize the multiple roles of banks in the process of transactions. Crucial for the banks is the risk of transfer of credits. By the transfer to the SPV and its legal outsourcing, the Bank redeemed all of the risks of their own loans. Furthermore, the advantage for lenders is to convert their illiquid assets into liquid assets.

As a result of the credit crisis we will see some significant problems, because the banks know after the failures of the uncertainty behind the loans. Not known which bank has which risks in the books. The banks no longer trust each other, trade with ABS breaks down, and they lend any more money. There is a crisis of trust government support is needed.



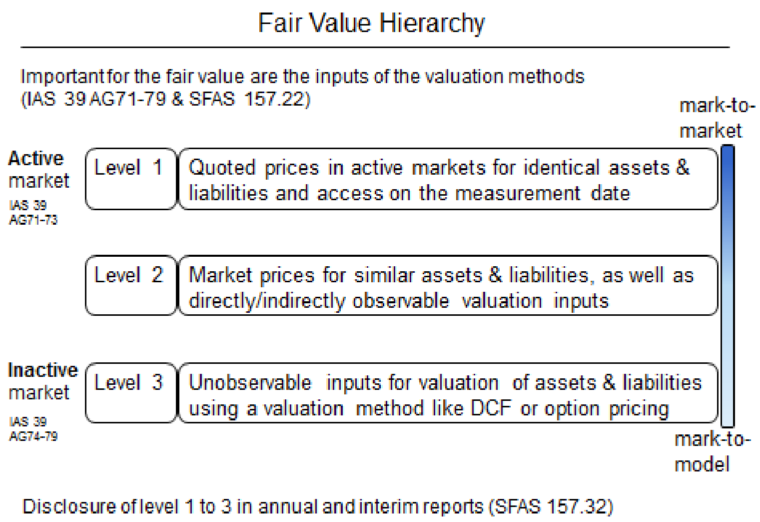
Role of accounting

The role of accounting focuses on the concept of fair value. Introduced as a market-based price and used in times of rising prices without resistance, this assessment scale in bad times is quickly becoming the topic of discussion.

Under IAS 39, financial instruments are put into four categories depending on predefined criteria. The categories are "loans and receivables", "held-to-maturity ',' available-for-sale" and "Financial Assets at Fair Value through Profit and Loss". The last category can again be divided into “held-for-trading" and "designated at fair value." The securitized loans are often found in the held-for-trading. There, in the subsequent measurement of any change in value of fair value should be recorded as income. This is not the case in the other categories. If a financial instrument once placed in one of the categories, it is generally not allowed for reclassification. This resulted in times of crisis to a large resistance in practice. Because the market for financial instruments, such as ABS, collapsed. This was an enormously large value loss for banks. IAS 39 requires that the fair value is first to use of an active market (mark-to-market) and made the assessment based on the fair value hierarchy (Fig. 2). However, the markets were becoming increasingly inactive because of the dwindling trade of the ABS. The separation of an active market versus an inactive was of central importance in the crisis. IAS 39 does not provide a basic definition of an active market. However, here help the standards IAS 36, 38 and 41. Should arise the fact that no active market exists, an inactive market can be assumed (mark-to-model). In the 5-level hierarchy finally the last step commands a valuation model. These valuation models were confronted with a huge criticism in the crisis, because some of their inputs must be determined subjectively from the company and the results are therefore extremely volatile.

Following the lead of U.S. GAAP, a scheme should be created, allowing a reclassification to another category. Since politics in October 2008 had a great hurry to change the regulations, the European Commission independently declared that it changes the standards for companies. To pre-empt the Commission, the IASB then - in an unprecedented action - changed the standard IAS 39, to political pressure. The actual process (due process) usually proceeding modifications to a standard has been completely undermined. Independently and without consulting the interested parties, the accounting changes were approved in record time. Recently, in accordance with IAS 39, certain reclassifications in so-called "rare circumstances" were permitted, which included the financial crisis. Thus, the IASB in this regard has adjusted IAS 39 to U.S. GAAP. There reclassifications in accordance with SFAS 115 and SFAS 65 are already possible. The companies are now allowed reclassifications of financial instruments from “fair value through profit or loss" into one of the other three categories. The standard was declared in October 2008 as a retroactive effect from 1 July 2008. That meant companies could finance their instruments between first July 2008 and 31 October 2008 on any date reclassify and thus achieve correspondingly any value within this period. Only since the first November 2008, the daily value of the reclassification has to be applied.

Also the disclosure of financial instruments will change a lot. The future disclosure requirements will soon be adapted to those in the U.S. GAAP. Therefore the IASB in October 2008 drafted amendments to IFRS 7 Financial Instruments: Disclosure. The comment period runs until 15 December 2008 and the standard came into force in July 2009. In U.S. GAAP already detailed quantitative information on the use of the respective stages have to be published, including the fair value hierarchy. This distinct requirement for disclosure of financial instruments will also be anchored in the IFRS. The measure aims at restoring confidence in financial reporting, after it has suffered from the financial crisis in the public a lot.



For the recognition and disclosure of SPEs, there is still no regulation, which is satisfying for the IASB. Since the demise of Enron, and also as a result of Arthur Anderson, are so-called SPE's in the criticism. However, it was apparently found no way to adequately consider their approach in accounting. According to IAS 27 and SIC 12, a SPE is to consolidate when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by the company (control principle). By an appropriate contractual arrangement the consolidation of the banking side can be avoided. They report in their financial statements under the heading "Off-Balance Sheet" of the SPE's, but without quantitative data. For this problem, no solution is found.

Reaction of the IASB

The IASB has taken in the wake of the financial crisis, the recommendations of the Financial Stability Forum. The expert panel has issued 67 recommendations to the G7 finance ministers, three of which the IASB has taken on the agenda. One recommendation concerns the fair value in inactive markets and the associated problems of measurement and disclosure. In this train the Expert Advisory Panel has been established to discuss the matter thoroughly. Members of the panel are amongst others the Big 4 accounting firms, UBS, Deutsche Bank, and IOSCO. The second recommendation concerns the non-recognition of SPE's. Changes should be taken, but that has not yet been established. The issue is currently being discussed at the IASB and in the fourth quarter of 2008 an exposure draft is planned. The third issue concerns the disclosure of financial instruments. This was already included in the draft of IFRS 7, which leans heavily on the U.S. GAAP.

Other steps of the IASB concerning inter alia was to restore the foundation of an international advisory group, together with the FASB to the confidence of investors, including a public discussion with international representatives from government, standard setters and users.

Open questions

It is questionable whether the fair value is efficient and works even in a crisis or through this policy the crisis has been overestimated? Accordingly, more changes would follow to IAS 39 to clarify the matter, especially in the case of illiquid markets.
Is the interference of politics in the standard setting appropriate? It demanded in October 2008 to change the standards so that banks have disclosed no unjustified losses. This should promote investor confidence. However, the accounts should show the truth and not what you want to present to investors during the crisis just to regain their trust. The accounting cannot pay sub-prime loans, but only reflect the facts. The changes already implemented in October 2008, remain inviolable, even though they were conducted without any further comment on the IASB. There can be no political interference in the standard setting process for accounting standards. The fair value approach has been attacked for promoting pro-cyclicality, but investors generally support the fair value.

Is another crisis in sight? After the subprime mortgages could follow the sub-prime commercial property, as the chief economist of the U.S. bank Goldman Sachs warned. Other hot spots are subprime or subprime credit card loans. This may not be prevented even by the best accounting.
Who are the winners? Where there are losers there must be winners, too. Every crisis is followed by an increasing regulation. The professional group of accountants could benefit. Their competence was not called into question in a crisis. For accounting firms could follow special tests and advanced testing. It is also expected at the international level a deeper control of banking supervision.